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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 66.

EMIL H. STRASSBURGER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE PETITIONER.

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BRIEF FOR THE PETITIONER.

Opinions Below

The majority and dissenting opinions of the Circuit Court of Appeals, Second Circuit, are officially reported in 124 Fed. (2d) 315; the memorandum opinion of the United States Board of Tax Appeals is not officially reported but is noted in 43 B. T. A. 1209.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered January 7, 1942 (R. 36). Petition for a writ of certiorari was filed on April 3, 1942 and granted on May 11, 1942. The jurisdiction of THIS COURT is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 938, U. S. C. A. Title 28, Section 347 (a)).

The grounds on which the jurisdiction of THIS COURT is invoked are:

1. The question presented herein is an important question of federal law which, so far as our research has revealed, has not been directly settled, but should be so settled, by THIS COURT.

2. The majority opinion of the Circuit Court concludes with this pertinent observation with respect to the issue presented: "It must be conceded, however, that the question is not free from doubt" (R. 34)

In the instant case, the majority opinion (R. 34) held that payment of a dividend in preferred stock to the sole stockholder of all the outstanding common stock resulted in a rearrangement of the corporate capitalization and changed the character of the sole stockholder's corporate ownership; that the sole stockholder received property rights of actual and exchangeable value and representing an interest different from that which his common shares represented. Even assuming such to be the facts, the taxpayer did not realize income and the cardinal fact remains that both before and after the stock dividend the sole stockholder actually owned the entire interest in the net value of the corporation.

3. The decision of the Circuit Court is in direct conflict with the decisions of other Circuit Courts on the same matter. *Sprouse* v. *Commissioner of Internal Revenue*, 122 Fed. (2d) 973 (C. C. A. 9th, 1941), cert. den. March 2, 1942, rehearing den. March 30, 1942, cert. granted May 11, 1942; *Clark* v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd, 1935), aff'g. 28 B. T. A. 1225; *Commissioner* v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th, 1934), aff'g. 26 B. T. A. 901, cert. den. 293 U. S. 570.

4. The majority opinion of the Circuit Court is in direct conflict with the principle underlying the decision of THIS COURT in *Eisner* v. *Macomber*, 252 U. S. 189. THIS COURT there held that a dividend payable in common stock to the holders of common stock, where only one class of stock was outstanding, was not constitutionally taxable as income because distribution of the dividend produced no change in the stockholders' proportionate interest in the corporation's net assets.

5. The dissenting opinion of Chase, C. J. (R. 35) should be considered by THIS COURT inasmuch as it correctly applies the principles established by THIS COURT.

6. Definitively to settle the law applicable to this and other cases now pending in other courts and involving the same question.

Statement of the Case

This case is presented to this Court upon order allowing certiorari to the Circuit Court of Appeals, Second Circuit (R. 36). Said Circuit Court of Appeals by judgment affirmed an order of the United States Board of Tax Appeals upholding the Commissioner's determination of tax liability (R. 36, 17).

The issues involved were not disputed and were presented to the Board on an agreed Statement of Facts (R. 12-14, 25-28).

Briefly, the facts are:

Petitioner on December 10, 1936, owned all of the stock consisting of 200 shares of common of the Corporation, E. H. Strassburger, Inc.

On December 11, 1936, the Corporation's articles of incorporation were duly amended for the creation and authorization of an issue of 500 shares of $100 par value, 7 per cent, cumulative, non-voting preferred stock.

On December 21, 1936, the board of directors of the Corporation held a meeting at which a resolution was adopted of which the following is material:

> "NOW, THEREFORE, BE IT RESOLVED, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock,

and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

"FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

On December 24, 1936, pursuant to the resolution adopted on December 21, 1936, 50 shares of preferred stock of the Corporation were issued to petitioner, the sole common stockholder who thereby became the sole preferred stockholder as well. At the time of the distribution of the stock dividend the Corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend, decreasing the surplus of the Corporation by $5,000 and increasing its capital stock in the same amount.

The single question is whether the so-called stock dividend, upon its mere receipt by petitioner, has been by law subjected to income tax and further, irrespective of the law, whether the same constitutionally may be subjected to income tax.

Specification of Assigned Errors to be Urged by Petitioner

The Court below erred:

1. In holding that the receipt by petitioner of a dividend in preferred stock paid by E. H. Strassburger,

Inc., which previously had only common stock outstanding, all of which was owned by petitioner, constituted taxable income.

2. In holding that the preferred stock dividend

(a) gave petitioner rights different from those which he possessed before;

(b) materially affected or changed the character of petitioner's corporate ownership;

(c) conferred upon petitioner property rights of actual and exchangeable value and representing an interest different from that which his common shares represented, and therefore gave rise to taxable income.

3. In holding that the petitioner received taxable income in the amount of the fair market value of the preferred stock dividend, resulting in a deficiency in income tax due by petitioner.

4. In failing to hold that there was no change in petitioner's proportionate interest in the corporation.

5. In failing to determine that the tax liability imposed upon petitioner is without warrant either under the United States Constitution, the Federal Statutes or the Regulations, with respect to the taxation of income thereunder.

6. In failing to determine that the Statutes and Regulations, insofar as the same may purport to tax the preferred stock dividend in question, are illegal, unconstitutional or void for want of certainty, clarity and definiteness and impose no tax basis or formula for the computation of tax liability.

7. In affirming the decision of the Board of Tax Appeals and holding that under the facts before the Court the taxpayer received taxable income.

Summary of Argument

The receipt by the petitioner, Emil H. Strassburger, of a dividend in preferred stock of E. H. Strassburger, Inc., which corporation previously had only common stock outstanding, all of which was owned by petitioner Emil H. Strassburger, does not constitute taxable income under the Federal statutes, regulations or Constitution.

The entire interest in the assets of the corporation represented by stock of the corporation, was owned by petitioner. He could never own, in fact or in law, anything more than the whole. The declaration of a preferred stock dividend may have changed *the evidence of* his ownership or interest in the corporation; it did not and could not, however, affect or change that ownership or interest.

Neither legalism nor abstruse principles of accountancy can possibly alter the simple fact here involved in the issue before this Court. In numerous cases this Court has held that fact and not fiction controls, whether it be for determining income or any other substantive right. Even if there were a wholesome purpose to be served by the attempted overthrow of fundamental law, the end would be wholly unjustified. But here there is no such purpose. Theoretically, the Government may collect taxes at an earlier date than the same could otherwise be collected, but the problem would not stop there. For even the Treasury Department must admit that if gains are realized by a fictitious increase in a stockholder's interest in corporate assets, similarly, a loss is suffered by a stockholder's decrease in such interest. In reality, of course, neither gain nor loss is realized.

Apart from the question of the constitutionality of such

a tax, the statute has not attempted to impose any such tax. Congress made clear that the determining guide for the taxability of stock dividends was *Eisner* v. *Macomber*, 252 U. S. 189, and not *Koshland* v. *Helvering*, 298 U. S. 441, or any other case. In other words, Congress said in so many words that if a stock dividend can be taxed under the principles of the *Eisner* case, it shall be taxed, but Congress did not say that any other decision could serve as the test for determining taxability.

Further, the statute, if it should be construed to warrant the tax, is vague, indefinite and uncertain, and in view of the fact that it imposes penalties for its violation, is clearly unconstitutional.

Statutes Involved

The statute involved is Section 115 (f) of the Revenue Act of 1936, c. 690, 49 Stat. 1688, and Art. 115-7 of Reg. 94 promulgated by the Commissioner of Internal Revenue.

* * * * *

Sec. 22. Gross Income.

(a) General Definition.—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *

* * * * *

Sec. 115. Distributions by Corporations.

(a) Definition of Dividend.—The term "dividend" * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *

* * * * *

Revenue Act of 1936, c. 690, 49 Stat. 1688:

Sec. 115 (f) relating to stock dividends and ART. 115-7 (Reg. 94) thereunder are set forth in full on this and the following page.

ARGUMENT

POINT I

The mere receipt of the claimed stock dividend in question does not under the Constitution, Statutes or Regulations constitute taxable income to the petitioner; any attempt so to impose such tax is unconstitutional and void.

For many years prior to 1936, all stock dividends were specifically made exempt from tax by statute; constitutionally, various stock dividends could not be taxed inasmuch as such stock dividends did not constitute taxable income.

Eisner v. *Macomber*, 252 U. S. 189.

It is elementary that all property received does not constitute taxable income under the Sixteenth Amendment to the Constitution of the United States, or even income.

The statutory provision, and regulation thereunder, relied upon by respondent to support the tax in question, are:

"Sec. 115 (f) Stock Dividends.

(1) General Rule. A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income

to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

"Art. 115-7 (Reg. 94) Stock Dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the Sixteenth Amendment to the Constitution. * * * The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificate plus the old representing the same proportionate interest in the net assets of the corporation as did the old." (Examples listed.)

We believe that the Regulation squarely covers the instant case and makes the claimed dividend non-taxable. In examining the Congressional purpose and intention we find the following explanation by Congressman Vinson, committee member in charge of the Bill, in connection with the Revenue Act of 1936, reported in the Congressional Record, Volume 80, Part 6, pp. 6214-15:

"Coming now to stock dividends, this is a field that has more or less been surrounded with mystery. Existing law provides that no tax shall be levied upon stock dividends. We strike that from this bill. • • •

"The kind of securities issued and the change in the proportion of ownership of a person in a corporation are the determining factors as to whether or not it is taxable income under the 16th amendment. • • •

• • •

"As we see it, a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership. • • •

"There are, however, many instances in which dividends in stock or bonds are issued which are realized taxable incomes under the 16th amendment. The yardstick of ownership in many cases is changed—that is, the relative proportion of ownership in the corporation by a shareholder is increased or decreased.

• • • p. 6309:

"The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of *Eisner* v. *Macomber* in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

This Court in *Eisner* v. *Macomber*, 252 U. S. 189, 207, which we accept as the law, although the respondent is in effect directly attacking the principle of that case, aptly defines the word "income" as follows:

"'Income may be defined as the gain derived from capital, from labor, or from both combined' . . . Here we have the essential matter: *Not* a gain *accruing*

to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description." (Italics the Court's.)

Towne v. *Eisner*, 245 U. S. 418, 426-7, defines the term "stock dividend" as follows:

"'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased .... The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest. * * * * *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560.' * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new."

Editorial comment is to the same effect. In Commerce Clearing House, Standard Federal Tax Service, 1941, Vol. 2, at p. 3096, the editors say:

"If there is only one class of stockholders at the time of the issuance of additional stock to all the stockholders, any dividend paid to all such stockholders in stock of the paying corporation, whether paid in common or preferred stock, would appear to be exempt under Section 115 (f), for the dividend results in no change in the proportionate interest of each stockholder in the earnings or in the assets of the corporation. * * *"

Only recently, the editors of the aforesaid Service reached the same conclusion, after reviewing all of the

decisions, including the Circuit Court decision in the instant case. (Commerce Clearing House, Standard Fed. Tax Service 1942, Vol. 1, Bulletin 9, August 5, pp. 657-662.) Notwithstanding several reported decisions relied upon by respondent which appear to justify the imposition of tax, the editors make the following significant observation: "Under the Act of 1936 and later Law such dividend would be taxable if there was other stock outstanding at the time of the dividend which did not receive a pro rata distribution." In other words where the outstanding stock did not share proportionately in the stock dividend then the dividend would be taxable; however, where all outstanding stock received a proportionate stock dividend, said dividend would not be taxable.

Sprouse v. *Commissioner*, 122 Fed. (2d) 973, (C. C. A. 9th), also pending before this Court, supports petitioner on facts similar in principle. There the stock was owned by numerous stockholders and not by a single stockholder as in the instant case. After discussing the facts and the meaning of the word "income" the Court made the following pertinent observations at page 976:

> "Generally, insofar as the stockholder is concerned, the three main differences in stocks are in the rights (1) to an interest in the assets of the corporation, the differences being in the amount of such interest and the preference it may have over other interests in the corporation; (2) to dividends, the differences being in the absoluteness of the right, and whether such right is cumulative; and (3) to manage and control the corporate venture by voting.
>
> "The Board was of the view, as appellee argues here, that if the stock distributed as a dividend, differed in its nature from that held by the stockholder, the latter derived income. In other words, differences in such characteristics as preference in interest in the assets and in dividends, and the right to vote, are proposed as the test to determine whether

the recipient of the stock dividend has derived income. We think such a test results from a misconstruction of the decisions of the Supreme Court.

"As is well known, a corporation, except in a few instances, is an entity, distinct from the stockholders. When it has earnings, the stockholders do not, by reason of that fact, have income. When it segregates those earnings, even though such earnings have accumulated in a surplus, and declares a dividend payable in money, then the stockholder receives income; or if the corporation takes from its surplus, assets and distributes them in kind to the stockholders, the latter derives income. If the corporation keeps its earnings or profits and allows them to accumulate thus building up a surplus, the surplus belongs to the corporation, not the stockholders, and while the value of the stock may increase, the stockholders do not realize on the profits until the surplus, or part thereof is distributed to them, or until they dispose of their stock.

"Where the corporation has more than one class of stock outstanding, and distributes a stock dividend to one class only, then the proportionate interests in the corporation are changed, because the class of stockholders who receive the dividend then have a greater interest in the assets of the corporation than those who did not receive the stock dividend. There being a change in the proportionate interests, the recipients of the stock dividend have derived income.

* * *

"Therefore, we believe the real test to be used in determining whether the stockholder who receives a dividend of stock in the same corporation has received income, is whether the distribution effects a change in the proportionate interest of the stockholders." (Italics ours.)

The minority opinion in the instant case in brief follows the substance of the position of the Court in the *Sprouse* case, *supra*.

Bass v. *Commissioner*, 129 Fed. (2d) 300 (C. C. A. 1st), is also similar in principle, the main difference being that the surplus was not transferred to capital. The net effect of the transaction, however, was that common stockholders received preferred stock. The Court unanimously vacated the order of the Board of Tax Appeals and remanded the case for proceedings not inconsistent with the Court's opinion.

Perhaps the most thoroughgoing of all the Board decisions on the subject is the case of *Horrmann, et al.*, 34 B. T. A. 1178. To the extent that the decision written by Board Member Arundell is pertinent to the instant case, we quote from page 1182 thereof:

> "* * * The dividend in *Eisner* v. *Macomber*, *supra*, was in common stock on stock of the same kind; here, it is in preferred stock on common stock, which was the only class outstanding. We held in *Pearl B. Brown, Executrix*, 26 B. T. A. 901; affd. 69 Fed. (2d) 602, that a dividend like the present one, namely, in preferred stock on common, where only common was outstanding, was a pure stock dividend 'constitutionally free from tax', following *Eisner* v. *Macomber*, *supra*. We said that its effect was 'a mere proliferation of existing interests'. Further:
>
> "'At the moment of change, each shareholder's proportionate rights were absolutely and relatively the same, except that each in the same ratio had preferred as well as common shares, a difference without significance here. These are the essential characteristics of a stock dividend—those which have always given point to the cases in which the question has arisen. *Gibbons* v. *Mahon*, 136 U. S. 549; *Towne* v. *Eisner*, 245 U. S. 418; *Eisner* v. *Macomber*, 252 U. S. 189; *La Belle Iron Works* v. *United States*, 256 U. S. 377; see also *Graves* v. *Graves*, 120 Atl. 420; *Kaufman* v. *Charlottesville Co.*, 23 S. E. 1003; *United States* v. *Siegel*, 52 Fed. (2d) 63.'"

After citing various other cases holding similarly because there was no severance of assets from the declarant corporations and because the stockholders' proportionate interest remained unchanged, the Board at pp. 1182-3 continued:

"We do not believe that the recent case of *Koshland* v. *Helvering*, 297 U. S. 702,* requires a different conclusion. The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock. There is, as pointed out in the *Koshland* decision, a distinction between cases like the *Macomber* case and those where 'the proportional interests of the stockholder after the distribution was essentially different from his former interest.

"'* * * Where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income'. The quoted words state the theory upon which the Board and the Circuit Court of Appeals proceeded in *Tillotson Manufacturing Co.*, 27 B. T. A. 913; affd. 76 Fed. (2d) 189. In that case there were both common and preferred stock outstanding when the dividend on the preferred was paid in common stock. * * *"

To the same effect are *Commissioner* v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th) aff'g 26 B. T. A. 901, cert. den. 293 U. S. 570, and *Clark* v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd) aff'g 28 B. T. A. 1225.

The Circuit Court, Sixth Circuit, and the Board, have also had occasion to consider the problem in the case of *Tillotson Manufacturing Co.*, 76 Fed. (2d) 189, aff'g. 27 B. T. A. 913, referred to in the *Horrmann* case herein

*Sic—298 U. S. 441.

above wherein the Board at page 916 commented as follows:

> "• • • the characteristic which gives it immunity from tax, not alone under the statute, *Towne* v. *Eisner*, 245 U. S. 418, but also under the Constitution so long as the income tax is unapportioned, *Eisner* v. *Macomber*, 252 U. S. 189, is that it represents nothing new or different from the original investment but only a further subdivision of its tokens. • • • Whether there has been a tax-free stock dividend is to be determined not by the terms used but by an analysis of the legal effect of what was done in the name of a stock dividend."

A recent Board of Tax Appeals decision tends to support petitioner.

See:

Charles F. Mitchell and Cora B. Mitchell, 45 B. T. A. 300 (1941) and

See also:

Chapman v. *United States*, 63 Ct. Cls. 106, cert. den. 275 U. S. 524;
Commissioners of Inland Revenue v. *Fisher* (1926), A. C. 395;
Commissioners of Inland Revenue v. *Blott* (1921), 2 A. C. 171.

It should be noted that Congress and the Courts have heretofore established as prerequisite to the taxability of a stock dividend that the interest be essentially different, substantially different, and we observe running through the entire Congressional, editorial and judicial discussions, the controlling criterion or determining factor, namely, the stockholder's relative proportion of owner-

ship in the corporation. Indeed in the Congressional discussions it has been called the yardstick, and the change in the law by the 1936 Act is stated not to strike at the decision in *Eisner* v. *Macomber, supra,* "in respect of a stock ownership where there is no change in the proportion of ownership by the shareholder." In the *Horrmann* case the Board held that the dividend was a pure stock dividend "constitutionally free from tax".

The Board of Tax Appeals, in the instant case, cited several decisions, to wit: *John M. Keister** 42 B. T. A. 484; *Koshland* v. *Helvering,* 298 U. S. 441; *Frank J. and Hubert Kelly Trust,* 38 B. T. A. 1014, remanded 106 Fed. (2d) 1002; *Albert E. Smith,* 39 B. T. A. 80. Those cases do not all involve the issue here presented but rather concern the basis for computing gain or loss. There is, of course, a very practical difference involved between the basis cases and dividend cases as will be pointed out later. Moreover, we respectfully submit that the *Koshland* case, fairly interpreted, does not support the imposition of tax herein. If it should be held that the Board cases are inconsistent with the principle which we urge, then we respectfully submit that those cases are wrong. There is no Circuit Court of Appeals decision supporting any of the said Board cases except the decision below; indeed the authority is to the contrary.

The court below, after reviewing the facts and the law, discusses the *Koshland* case, *supra* (R. 34), and concludes that the claimed dividend in question paid to the petitioner herein constituted taxable income.

In the *Koshland* case, however, both preferred and common stock were outstanding at the time that the common stock dividend was declared in favor of the preferred stockholders. This fact, in the words of the Circuit Court below, is stated as follows (R. 34):

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* Reversed under name of *Sprouse* v. *Commissioner, supra.*

> "This expression of opinion would dispose of the case at bar were it not for the fact that in the *Gowran* case, as in *Koshland*, there were two classes of stock outstanding when the dividend was declared; hence the stock dividend in each of those cases changed the stockholder's proportionate interests in the net corporate assets. Here, however, there was only one class of stock outstanding and but a single stockholder, who after, as before, the dividend owned the entire beneficial interest in the net assets of the corporation."

Why this all important fact noted by the Circuit Court as the real difference between the *Koshland* case and the case at bar, was not determinative, it is difficult to understand. In the words of the Court, the following is the explanation (R. 34):

> "Nevertheless, the rearrangement of corporate capitalization so that the petitioner held preferred as well as common stock did change the character of his corporate ownership. • • •"

If there is merely a rearrangement of corporate capitalization or a recapitalization, the stock would not be subject to tax under the law, Revenue Act of 1936, Section 112 (b) (3) (g) (D), *Bass* v. *Commissioner, supra.* And respondent did not apply for certiorari in the *Bass* case. Indeed, viewed realistically, there is no stock dividend involved, but a rearrangement as the Circuit Court below said or a recapitalization. Frankly, we do not understand what the Court means by the character of the petitioner's ownership. Indeed, the true character of petitioner's ownership in the corporation was the entire ownership of the equity, and it is immaterial whether that equity is reflected by shares of preferred stock or shares of common stock or both. The Court in the *Sprouse* case,

supra, held that the true test was "whether the distribution effects a change in the proportionate interest of the stockholders." An entire interest can only be decreased, it may never be increased, and no abstruse metaphysics can change that simple fact of arithmetic.

The Court below further pointed out (R. 34) that the preferred stock had prior right to dividends and a preference on liquidation, and that these rights could be disposed of without affecting the voting control residing in the common stock (R. 34). The same contentions did not impress the Court in the *Sprouse* case. Further, such difference is one of form and not of substance in view of the fact that all of the equity rested before and still rests with the petitioner.

Moreover, it is unimportant that preferred stock may be disposed of without affecting voting control, for the sole common stockholder may likewise dispose of a portion of his common stock without affecting voting control. But *Eisner* v. *Macomber*, *supra*, held that a dividend of common on common is not taxable.

Further, if the theory of the tax were to prevent tax avoidance, which is not urged and which is not in issue, the law clearly covers such situation, for under Section 115 (g) of the Revenue Act of 1936 the cancellation, redemption or retirement of preferred stock is made taxable.

In reality, what is viewed by the Court below as taxable, is not property, but an occurrence or process of "the rearrangement of corporate capitalization" producing a change in the "character" or "quality" of the stockholder's "corporate ownership". It is the transformation in the so-called character or quality of the stockholder's interest which is being taxed, and not the actual product of the transformation. For the total product of the transformation is quantitatively neither more nor less after the change than before the change. The transforming process is obviously neither property nor an interest

in property and hence cannot constitute "income". To tax the transforming process under the guise of taxing its product is to tax something which, although it may possibly be made the subject of taxation, is nevertheless plainly not "income". To hold that such a stock-transforming process is taxable, the same as if it were "income", is to employ the judicial process for the purpose of extending taxation into a domain not yet arrived at by Congressional enactment.

Viewed from every conceivable angle and analyzed with every conceivable theory in mind, there still appears no justifiable basis for the imposition of tax liability.

To justify the tax in the instant case the Court below seized upon the statement in the *Koshland* case which sustained the imposition of tax because the shares received by the recipient gave him a "different" interest. However, the word "different" means a difference in substance and not a difference in form and was so used in the *Koshland* case. The whole principle of our Constitution preventing discrimination requires that the difference be one of substance. Certainly Congress may not discriminate, taxwise or otherwise, against red headed men or men who wear odd colored neckties. These classic school room examples are elementary principles, and yet respondent proposes just such discrimination. The learned majority below (R. 34) said: "In our opinion the case at bar is governed by the *Koshland* principle rather than by that enunciated in *Eisner* v. *Macomber*." Our answer is that the two cases present no conflicting principles and in the language of the Court in the *Sprouse* case the supposed conflict "results from a misconstruction of the decisions of the Supreme Court."

Rather do we urge as the sound and correct determination of the question presented the minority opinion of the Court below (R. 35), which requires as prerequisite to taxable income an increase in the stockholder's proportionate interest in the net assets of the corporation.

This simple criterion is we submit, the true meaning of *Koshland* v. *Helvering, supra.* Indeed, the language used fairly permits no other meaning. It was so construed by the Court in *Insull* v. *Commissioner,* 87 Fed. (2d) 648, 651 (C. C. A. 7th), rev'g. 32 B. T. A. 47, 567, 1070.

Doubt existed as to the correctness of the decision even in the minds of the majority below for it concluded its opinion as follows (R. 34):

> "It must be conceded, however, that the question is not free from doubt. * * *"

If a "different interest" meant literally what the majority stated it meant, then even in *Eisner* v. *Macomber* the stock dividend would be taxable, because the stockholder after the dividend held two pieces of paper where formerly he had only one piece of paper; he had something different, but of course, this difference was not of substance. An understanding of the nature and background of the litigation involving stock dividends makes clear what this Court meant in *Koshland* v. *Helvering* when it spoke of a different interest, if indeed, the language itself were not sufficiently clear, as we submit it was.

It is submitted that the learned majority below failed to recognize the true use of the word "different" which rightly construed may give rise to taxable income. For example, even in *Marr* v. *United States,* 268 U. S. 536, 541-542, the Court pointed out that there was a very real difference under the facts of that case as regards the interest of the stockholder after the stock dividend. The Court recognized the fundamental test as we have urged it, in the following language:

> "The case at bar is not one in which after the distribution the stockholders have the same proportional interest * * *"

Further, the Treasury Department itself interpreted the question correctly, and in support of petitioner's position. In Article 115-7 of Regulations 94, set forth on page 9 herein, it appears that the word "different" as used in the *Koshland* case means different in substance, a change in the stockholder's proportionate interest. This obvious point has already been noted herein and need not be labored.

While the Treasury Department has since eliminated practically all of Article 115-7 from the current regulations (T. D. 5020, November 15, 1940) it remained unchanged in Regulations 94 applicable to the instant case until recently, (T. D. 5110, January 19, 1942). The change shows a significant contemporaneous construction of the Statute by those charged with the enforcement thereof.

It should be noted that the sound body of law prior to the decision in the *Koshland* case held that the dividend in question was not taxable. We have already pointed out that even after the *Koshland* case, the Board decided in the *Horrmann* case that the dividend was still not taxable, distinguishing the *Koshland* case from the one there under consideration. The Board, at page 1182, says of the Koshland case:

> "The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock. • • •"

Also note the recent *Mitchell* case, *supra*, decided by the Board of Tax Appeals.

Moreover, in the instant case we are dealing with but a single stockholder who had no more and no less after the stock dividend than before, who in the language of Chase, C. J. (R. 35) "owned exactly the same interest in the net value of the corporation, because he always owned it all" • • • "and therefore the real basis of decision

in the *Koshland* case is lacking and that of *Eisner* v. *Macomber* (*supra*) 252 U. S. 189, does, I think, apply. See *Sprouse* v. *Commissioner*, 122 Fed. (2d) 973." Irrespective of nice reasoning, the simple fact is that the petitioner neither in theory nor in law received taxable income or any kind of income upon the receipt of the so-called stock dividend.

As was aptly said by the Court in the recent case of *Dreyfuss* v. *Manning, Collector*, 44 Fed. Supp. 383:

> "To reason to the contrary, makes it necessary to arrive at the conclusion that the whole can be greater than the sum of its parts. Even in this advanced age, wherein thought is being tested by science and invention, no such feat as yet has been accomplished."

The *Dreyfuss* case, *supra*, is a practical and sound decision analyzing the issue here before the Court. In concluding its opinion the Court said with respect to the instant case:

> "In *Strassburger* v. *Commissioner*, 124 F. (2d) 315, the majority opinion is in direct conflict with the result arrived at here, but it should be noted that the opinion concedes that 'the question is not free from doubt.' Judge Chase, in dissenting, says 'But surely the case just mentioned (the *Koshland* case) must rest upon firmer ground than a change in the kind of shares of stock a stockholder has as the result of a dividend of stock on stock. There must also be a change in his proportionate interest in the corporation's net assets in order to have what is known as a "realization" of income.' With this dissent I find myself in full accord for the reasons above stated."

Lawyers, accountants and economists all support the fundamental principle underlying petitioner's case. Among the various articles on the subject are: Mertens, "Recent

Income Tax Trends in Stock Dividend Cases", Cornell L. Q. June, 1942; Seligman, "Are Stock Dividends Income?", 9 Am. Ec. Rev. 517; Montgomery, Federal Tax Handbook (1933, 1934) 296; Dohr, "Income Divorced from Reality", 66 Journal of Accountancy 361; Powell, "Stock Dividends, Direct Taxes and the Sixteenth Amendment", 20 Col. L. Rev. 536; Clark, "Eisner v. Macomber and Some Income Tax Problems", 29 Yale L. J. 735.

One of the ablest presentations of all phases of the subject appears in *Mertens'* article, *supra*. After analyzing the underlying legal and economic principles, the author concludes (474):

> "Where there is but one class of stock outstanding, there is no taxable dividend upon the receipt by the stockholder of a new class of stock which gives the recipient evidence of certain preferences in the distribution of earnings, even though the new preferred stock is cumulative or does not carry voting rights. • • •" (See also same article at p. 458.)

It should also be noted that the test based on what is called a "substantially different interest" evolved from exchange or reorganization cases and not dividend cases (See *Mertens*, Cornell L. Q. *supra*, at p. 468). There the stockholder ordinarily was entitled to use as his basis the cost or other basis of his original stock and the gain realized was limited to the difference between the cost and the value of the new interest acquired upon the reorganization or exchange. But with stock dividends, the gain would be treated as the fair market value of the new stock. Practically, therefore, the result would be far more burdensome in the case of stock dividends such as the instant case. The result in dollars and cents of the application of the principle to stock dividends may have prompted this Court in *Eisner* v. *Macomber*, *supra*, at

page 203 quoting from *Towne* v. *Eisner, supra,* to observe that "if the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed * * *".

Realistically, the so-called stock dividend in question not only gave the taxpayer nothing, but actually took away something from him. For example, the corporation's surplus was larger prior to the payment of the dividend than after payment and the sole stockholder had a larger potential from which he could receive actual cash dividends. The creditors of the corporation, for whom the capital is said to constitute a trust fund, had a larger measure of protection after the amount of the dividend was debited against surplus and credited to capital. Petitioner therefore lost a potential, was further removed from realization. Assets otherwise available for distribution had become frozen into the capital structure. As has best been said by this Court in *Eisner* v. *Macomber,* p. 211:

> "A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution."

Practically, the Government may not gain in dollars and cents by the principle sought to be established herein. For even the Treasury Department must admit that if gains are realized by a fictitious increase in a stockholder's interest in corporate assets, similarly, a loss is suffered by a stockholder's decrease in such interest. In

reality, of course, neither gain nor loss is realized. If gains are to be accelerated, likewise losses.

POINT II

Apart from the Sixteenth Amendment, the Statute and Regulation, construed in the light of legislative history do not impose any income tax on the so-called stock dividend, but if they purport to impose such tax, are void as a matter of constitutionality.

We also contend that as a matter of construction, Congress has not attempted to tax the so-called dividend in question. How shall the Courts construe the amendment if not in the light of what the framers of the Statute said? They said, as we have shown before, that the stock dividend in question received by petitioner herein is not taxable and was not intended to be taxed, even after the change in 1936. They said that they wanted to extend the tax to cover cases permitted by the decision of *Eisner* v. *Macomber*, *supra*, but that the instant case was not one of the cases which could constitutionally be affected. (See Legislative History as set forth in Congressman Vinson's remarks, pp. 8-9 herein.)

We submit, further, that even if this Court should decide that the so-called dividend received by the petitioner is constitutionally taxable, notwithstanding *Eisner* v. *Macomber*, the dividend still would not be subject to tax because Congress under the 1936 Act accepted as the controlling constitutional criterion the Supreme Court decision in *Eisner* v. *Macomber* and not the decision of the Supreme Court in any other case. Therefore, as a matter of construction stock dividends now subject to tax are such dividends which the Supreme Court had in *Eisner* v. *Macomber* permitted to be taxable. Even assuming for the sake of the argument that Congress could sweep aside

all standards and permit tax to be imposed on the basis of what may now be held constitutional, Congress has not yet done so and the Courts will not extend legislation beyond its clear legislative limits.

It is one of the elementary canons of taxation that a tax statute must be certain, clear and definite. Particularly is this true where penalties and imprisonment may be imposed for violation thereof. As heretofore pointed out the Statute may not, under the Sixteenth Amendment, impose an income tax on the stock dividend in question. However, if it should be so construed to impose a tax, then we respectfully submit that it is void as a matter of constitutionality. What has Congress said to fix tax liability herein sought to be imposed? It has said that if the dividend is not constitutionally taxable it may not be taxed. The Regulations said it affirmatively. The Sixteenth Amendment said as much, but certainly no one could soundly argue that taxes can be imposed and collected on the strength of a mere declaration that everything that is constitutionally taxable must be included in a taxpayer's return and that a failure will result in severe pains and penalties. A declaration of purpose or policy is not a tax law. There must be definiteness, certainty, clarity, a basis or formula. A statute which requires a taxpayer at his risk to be a constitutional lawyer appears hopelessly invalid.

In view of the foregoing, it is respectfully submitted that the receipt by petitioner of the preferred stock dividend did not constitute taxable income.

Conclusion

For the reasons stated and on the authority of the cases cited herein, we respectfully submit that the judgment below should be reversed.

Respectfully submitted,

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With him on the brief,
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